



Directorate of
Intelligence

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**International
Economic & Energy
Weekly**

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3 February 1984

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DI IEEW 84-005
3 February 1984

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**International
Economic & Energy
Weekly**

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**International
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Synopsis

1	Perspective—<i>Western Europe: Welfare Versus Defense</i>	25X1
	Demands for state services and payments are rising rapidly while revenues are failing to keep up. The heavy welfare burden has already forced reductions of the modest increases in military spending agreed to by NATO, and most governments intend to make further cuts in planned increases in defense spending.	25X1
17	Western Europe: Pressures on Welfare Spending and Implications for Defense	25X1
	The budgetary problems that most West European governments confront are due in large part to the huge increases in welfare spending that have occurred during the last two decades.	25X1
23	France: Options on Austerity	25X1
	President Mitterrand appears determined to give industrial modernization and the battle against inflation priority in 1984. Pushing austerity much beyond this year would cost him support from the left, and he may attempt to shift his political base toward the center.	25X1
27	Lebanon: Economic Impact of Continuing Hostilities	25X1
	The normal resilience of the Lebanese economy is being sorely tested by nearly a year of sustained violence. It is unlikely, at least in the near term, that the Gemayel government will be able to deal effectively with its economic problems or stem the decline in confidence.	25X1
31	Iran: Trade Boom Masks Domestic Breakdowns	25X1
	Bureaucratic mismanagement, war-related disruptions, massive corruption, and ideological rigidities have stifled the Iranian economy despite a strong oil export performance over the last two years.	25X1

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Canada's Aerospace Industry: A Troubled Future

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Canada's aerospace industry is counting on the government to continue covering its losses during the present slump and to increase other forms of support in the future. We believe that Ottawa will step up its support for the aerospace sector but doubt the goal of doubling sales by 1984 can be realized.



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India's Green Revolution: The Bills Come Due

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Although India is looking forward to a record foodgrains harvest during the 1983/84 season, the country's agricultural prospects are clouded by slower growth in yields and rapidly escalating production costs. Any government move to reduce agricultural subsidies will be difficult because farmers represent an increasingly important political force.



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Perspective***Western Europe: Welfare Versus Defense***

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The West European welfare state is in crisis. Demands for state services and payments are rising rapidly while revenues are failing to keep up. In France and Italy, Socialist-led governments are attempting at least to restrain the further growth of social welfare spending. Conservative or Christian Democratic governments in the United Kingdom, West Germany, Belgium, the Netherlands, and Denmark are committed to trimming welfare benefits and reducing the state's social and economic role. The heavy welfare burden has already forced reductions of the modest increases in military spending agreed to by NATO, and most governments intend to make further cuts in planned increases in defense spending.

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Public pressures limit the ability of governments to cut back social welfare programs, especially in the absence of even deeper cuts in defense. Recent opinion surveys in the United Kingdom, France, West Germany, Italy, Denmark, Belgium, and the Netherlands confirm the West Europeans' strong support for social welfare programs and their skepticism about military spending. Although some prefer to see the fiscal policy dilemma solved by government borrowing, most oppose higher taxes or cuts in social welfare programs and prefer reductions in defense spending.

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We expect governments to opt for a combination of these approaches. Because social programs consume a large proportion of public budgets, austerity limited to other areas is unlikely to solve governments' fiscal problems. Economically necessary welfare cutbacks, however, could politically weaken northern Europe's fiscally conservative governments, particularly in the face of high unemployment and sluggish economic growth.

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We believe the need to trim welfare spending will prevent significant military spending increases in most West European countries. Because their publics consider defense costs the major cause of deficits, governments will be unlikely to promote defense increases while cutting back in other areas. Most West European governments are unlikely even to approach NATO's target of 3-percent real military spending increases in the next few years, and in some countries real military spending may actually decrease. As a result, planned equipment modernization programs are likely to be delayed or canceled, and overall military capabilities may decline.

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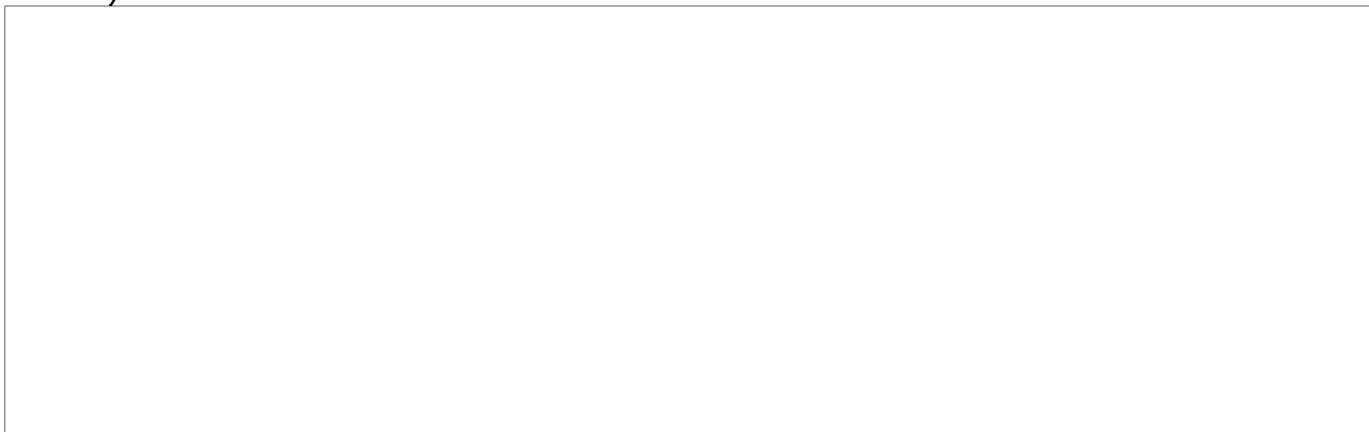
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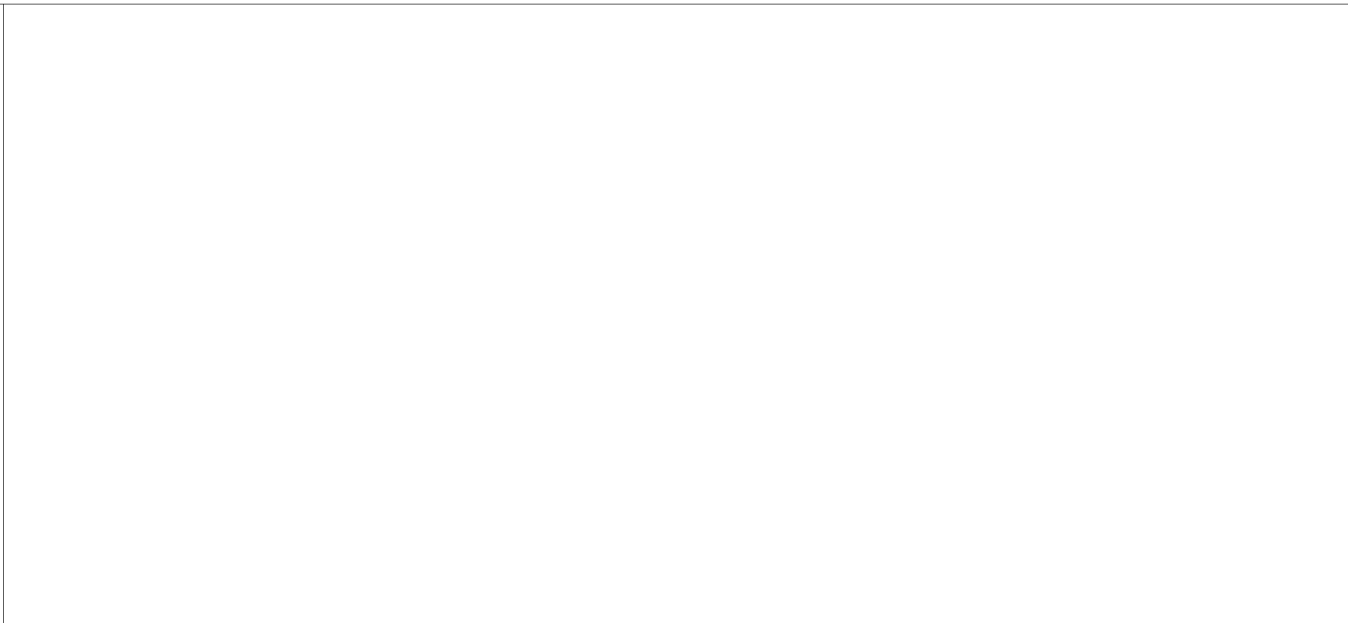
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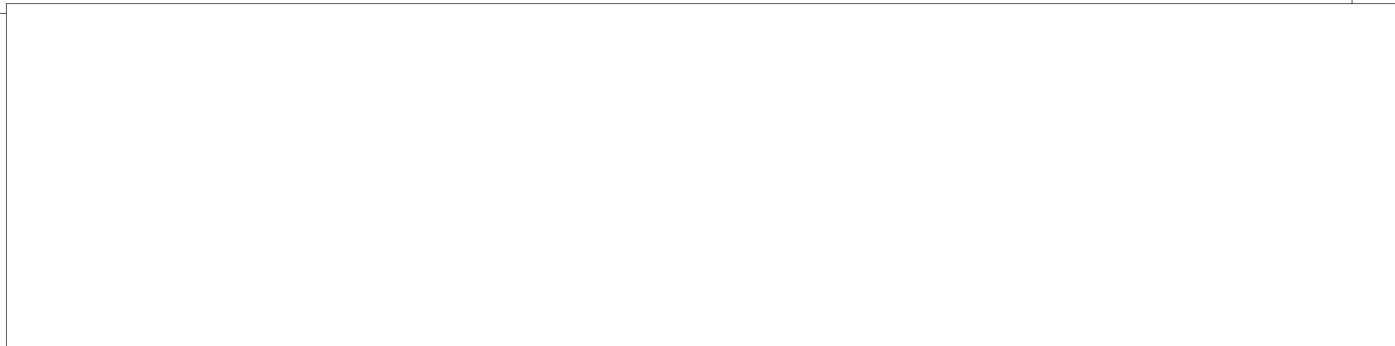
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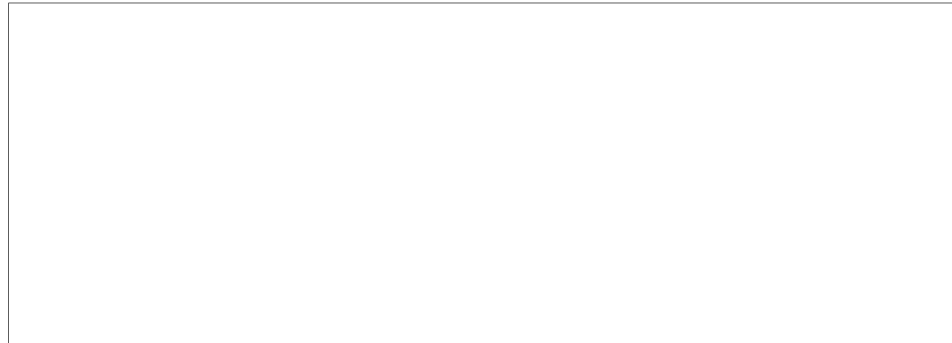


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*Abu Dhabi Slows
Progress of Upper
Zakum Project*

Abu Dhabi, the largest oil producer in the United Arab Emirates (UAE), is delaying further development of its offshore Upper Zakum oilfield because of funding cutbacks and the OPEC production quota. Abu Dhabi originally intended to produce 100,000 to 150,000 b/d from Upper Zakum in the summer of 1983 and build capacity to 500,000 b/d by late 1984. Actual production, which began in early 1983, was only about 25,000 b/d at midyear and currently is averaging about 75,000 b/d. Officials of the Abu Dhabi National Oil Company reportedly now say that the commissioning of 30 additional platforms has been postponed until at least mid-1985, and only 12 of the 25 platforms commissioned thus far presently are in operation. Because of the 1.1 million b/d output quota imposed on the UAE by OPEC, production at other fields cannot be reduced sufficiently to make room for Upper Zakum and still meet the UAE's associated gas needs. Curtailment of the Upper Zakum project will have a significant impact on overall capacity development and future supply availability in Abu Dhabi—one of the few OPEC producers that had planned to continue increasing capacity over the next few years.

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*Pipeline Agreement
Between Jordan
and Iraq*

Jordan and Iraq have agreed in principle to the construction of a pipeline across Jordan to the Red Sea, according to press reporting. It will take up to two years to build the proposed pipeline, which will have a capacity of 1.5 million barrels per day. The project will cost a minimum of \$1.5 billion, and Jordan and Iraq probably will need other government loan guarantees to arrange financing. The prospect of increased oil revenues would give a psychological boost to the financially pressed Iraqis and remove some of the domestic pressure to intensify the war. It also may induce Iran to revise its war-of-attrition strategy.

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*New Venezuelan
Energy Minister*

Venezuela's President-elect Luisinchi has named Arturo Hernandez Grisanti as Minister of Energy and Mines. Grisanti has a reputation of being strongly nationalistic, which was earned during negotiations over the nationalization of US oil companies' assets. The Venezuelan press has called Grisanti "the architect of Venezuelan oil nationalization" because he authored the 1970 tax that set a 60-percent flat rate on oil-derived income. Grisanti, who will again become involved in unsettled questions of oil company compensation, claims he has moderated his tough stance on the issue. Grisanti has indicated that

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Venezuela's role in OPEC will be basically unchanged. According to OPEC representatives, the new minister sees Venezuela as a moderator in OPEC meetings, and already has held preliminary consultations with a number of OPEC countries and with Mexico. [REDACTED]

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*Japan Agrees To Take
Australian LNG*

Preliminary engineering work on Australia's \$2.5 billion Northwest Shelf LNG project—which has been postponed since early 1983—is now expected to begin this month. [REDACTED] In January, Japanese firms agreed to take delivery of the LNG beginning in late 1988. The firms cited a recent reassessment of Japanese energy needs in the 1990s, which indicated that Australian LNG will have a ready market in Japan. [REDACTED]

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*South Korea Reduces
Energy Demand*

South Korea has scaled back its energy consumption projections for the next three years because of increased conservation. Last year, energy consumption grew only 5 percent, while GNP increased 9 percent. The projected growth in oil and anthracite coal consumption has been lowered from earlier forecasts, while bituminous coal demand will grow more rapidly than previous projections. Seoul is boosting bituminous coal imports to diversify energy sources for power generation and to reduce its heavy reliance on imported oil. Nuclear energy will account for a slightly lower share of consumption in 1986 than originally projected because planned completion dates for four plants under construction have been stretched out by at least a year. Plans for importing LNG have been delayed as well. [REDACTED]

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South Korea: Energy Consumption, by Source

Percent

	1983	1986 (Projected)
Total	100.0	100.0
Oil	56.8	50.9
Anthracite coal	20.1	17.4
Bituminous coal	12.5	16.8
Nuclear	4.5	9.2
Hydro and firewood	6.1	5.7

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*Zimbabwe Faces
Fuel Squeeze*

Sharply reduced foreign exchange availabilities and renewed insurgent attacks on a Mozambican pipeline could force the Mugabe government to adopt fuel rationing. [] Harare reduced its fuel stocks by nearly 30 percent in late 1983 because of foreign exchange shortages and the government has been considering cutting imports by 25 percent during the first half of 1984 to save foreign exchange. []

[] South African-backed insurgents early this week made their first attack in a year on the pipeline in Mozambique through which Zimbabwe receives 95 percent of its fuel imports. The extent of damage has not yet been determined, but Zimbabwe has little cushion against a prolonged supply interruption. Fuel shortages would have the greatest impact on urban consumers; Harare is unlikely to cut fuel supplies for agriculture because this would jeopardize harvesting and distribution of the corn crop—the dietary staple—that begins in April. []

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International Finance*Mexico's Slow Progress
on Jumbo Loan*

Mexico City's 1984 jumbo loan was not fully subscribed by the 27 January deadline, and we believe final agreement may slip until late February or early March. While one press report said \$3.6 of the \$3.8 billion had been raised, []

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Arab, European, and some US regional banks oppose the loan's easier terms, including lower interest rates and management fees, a 10-year repayment term, and a more than five-year grace period. []

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[] the larger US banks are tired of "topping off" undersubscribed LDC loans, we believe they are likely to make up any small shortfall. Unlike 1983, the delay in arranging the loan probably will not result in foreign financing gaps—net foreign reserves totaled about \$5 billion in October. []

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*Indonesia Testing the
Loan Market*

According to the US Embassy in Jakarta, Indonesia is seeking a \$500 million loan syndication to maintain its foreign financial reserves at high levels. []

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[] the terms probably would be 0.75 percentage point over LIBOR for 75 percent of the loan and 0.2 percentage point over the US prime rate for 25 percent of the loan. Last March, Indonesia obtained a \$1 billion jumbo loan, one-half of which was priced at 0.5 percentage point over LIBOR. In subsequent borrowings during this year, Jakarta found it necessary to pay higher spreads. []

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We believe bankers will respond favorably at the higher terms. Jakarta has successfully imposed a series of stringent austerity measures, without incurring domestic unrest, that have improved its international payments position and enabled the government to rebuild official foreign exchange and gold reserves from a low of \$3.2 billion last April to more than \$4.5 billion by yearend. One Indonesian official told Embassy officers that Jakarta is determined to maintain high foreign financial reserves as a means of maintaining confidence in the rupiah. []

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*Dominican Republic-
IMF Negotiations*

The US Embassy expects talks between the Dominican Republic and the IMF on requirements for the second year of a three-year Extended Fund Facility loan to last at least two more months. Discussions stalled in December when Santo Domingo rejected IMF proposals for eliminating foreign payments arrears, sharply cutting government spending, and unifying the country's dual-exchange rate system. The government complained that the measures would cause inflation to triple and would reduce real income. Santo Domingo, nonetheless, recently announced a series of foreign exchange reforms, including a float of the unofficial exchange rate, a shift of additional import categories to the costlier unofficial foreign exchange market, and an extension of foreign exchange incentives to exporters. In addition, the government has suspended Central Bank credits to the public sector. [REDACTED]

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The recent measures appear aimed at slowing the demand for US dollars. Despite these efforts, the government will have little bargaining power with the IMF—it missed its 1983 program targets by a wide margin. President Jorge Blanco will face labor opposition should he pursue new austerity measures because of high unemployment and recent declines in real wages. [REDACTED]

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*Syria Considers
Scheme To Ease
Foreign Exchange
Shortage*

The Commercial Bank of Syria, the country's central bank, has proposed to the government new regulations in an attempt to gain access to additional foreign exchange reserves. Private-sector importers would be allowed to open convertible foreign currency accounts with the Commercial Bank from funds in accounts abroad. After the funds had been on deposit for three months, the importer could draw on the money to pay for imports of industrial raw materials, spare parts, machinery, or seeds. Presently, private-sector importers must smuggle goods into Syria or wait a year or more for applications for letters of credit to be approved. As a result, shortages have developed for manufactured goods and raw materials. [REDACTED]

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The new regulations have been under consideration by the government for several weeks, prompting Commercial Bank officials to fear that they may not be approved or may be substantially altered. Government policy in recent years has been to weaken the role of the private sector, according to the US Embassy. Even if the current plan is approved, importers are unlikely to transfer large sums back to Syria out of concern that the government someday might confiscate their foreign exchange. A Commercial Bank official told a US Embassy officer that the bank needs \$250 million each month to finance import transactions at an acceptable level but is currently receiving only \$125 million to \$150 million per month; the new regulations are unlikely to make up the difference. [REDACTED]

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Global and Regional Developments

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✓ *Canada To Change
Foreign Investment
Review Act*

Ottawa recently announced that it would comply with a GATT panel report, which found the domestic procurement requirements of the Foreign Investment Review Act (FIRA) to be trade disruptive. FIRA Commissioner Robert Richardson has informed US officials that rewording of the Act's offending sections should be completed before a full GATT ruling on the report later this month. Richardson restated, however, his belief that Canada's past application of FIRA's policies did not warrant the criticisms made at the GATT. Instead, he blamed the ruling on an unclear phrasing of FIRA's intent; he claims the Act was designed to require equal, not favored, opportunities for Canadian suppliers. Minister for International Trade Gerald Regan has provided even stronger support for FIRA, promising that the changes will not reduce the opportunity for Canadian companies to sell goods and services to foreign-owned companies operating in Canada. Administrative changes in the Act over the past few years, primarily resulting from the depressed economic conditions in Canada, have made FIRA less restrictive in an effort to spur foreign investment. Ottawa's reactions to the GATT panel report, however, indicate that the Liberal government still considers FIRA to be an essential part of national economic development policy.

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*EC Extends Steel
Quotas*

EC Industry Ministers last week agreed to extend the expiring production quotas for the Community's depressed steel industry through 31 December 1985. EC officials were concerned that Italy might block the quota renewal or press for a shorter extension if Rome's request for an additional allocation of 1.2 million metric tons was not met. The Italians instead settled for an extra 450,000 tons and plan to challenge the EC in the European Court of Justice in an effort to gain an additional 600,000 tons.

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The quota system is an essential part of the EC Commission's overall program to revitalize the steel industry. The Commission hopes the extension will provide greater stability and price discipline in the EC steel market to permit the phaseout of excess and inefficient capacity. Without the production restrictions, supply would quickly outstrip demand.

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*East Germany Buys
Iranian Oil*

Iran announced in late January that East Germany has agreed to buy 30,000 barrels per day of Iranian oil in 1984 at official prices, [REDACTED]

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[REDACTED] We estimate that the roughly \$300 million deal will provide 6 to 8 percent of East Germany's total oil imports and 30 to 40 percent of its imports of crude from non-Soviet sources this year. The agreement furthers an upward trend in Iranian-East German commercial relations in recent years, [REDACTED]

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[REDACTED] part of a deliberate East German effort to expand bilateral ties. East Berlin has helped pay for previous oil purchases from Iran with deliveries of arms, vehicles, and machinery. The East German trade delegation in Tehran last week probably was trying to drum up still more sales to help keep bilateral trade in rough balance. East Germany is likely to use some of the oil domestically, while reexporting most as refined products. [REDACTED]

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National Developments*Developed Countries**Israeli Bond Market
Under Pressure*

Government bonds linked to the consumer price index are being dumped onto financial markets in such quantities that the Bank of Israel has been forced to intervene. The US Embassy reports that the bank purchased \$100 million worth of the bonds in January—most in the last 10 days of the month. Bank officials believe that recently imposed credit restrictions have left many businesses strapped for cash, prompting some to sell bonds to pay their bills. An erosion of public faith in the government's ability to deal with economic problems also may be a factor; promises made to a small coalition party to ensure its vote on a no-confidence motion on 25 January undermine the austerity budget approved by the Cabinet just a few days earlier. If the selling wave spreads to the stock market, the government will be forced to spend large sums of money to prevent another stock market collapse such as occurred last October. [REDACTED]

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Meanwhile, labor unrest continues. Ten private-sector unions, led by the metal workers with 100,000 members, are demanding the same 5,000 shekel—\$41 at the current exchange rate—per month wage increase given public-sector employees last month. In the public sector, the clerks union won additional monthly pay hikes of up to \$16 for lower income workers after staging a three-day strike. The engineers union held a one-day strike on 29 January in government-owned defense industries, and most employees in the Land Registry Office in the Ministry of Justice are refusing to serve the public. A Histadrut official told a US Embassy officer that, in a 23 January meeting, the Histadrut set its priorities for the upcoming wage negotiations with the government and the Manufacturers' Association; they include "fighting to maintain real wages," promoting a national minimum wage equal to 50 percent of the average wage, and adjusting tax brackets to help low-income groups. [REDACTED]

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*West German Exports
Boosted by the Strong
US Dollar*

West German exports to the United States soared 38 percent and to Canada 50 percent in October-November over the previous two months. Sales to the United States represent only 7 percent of total West German exports, but the strong dollar (up 10 percent against the deutsche mark in the last six months) also makes West German products more competitive in third markets such as Canada. In addition, Bundesbank profits of \$4.4 billion in 1983, in large part from sales of dollars and interest earnings on dollar assets, will be transferred to the federal budget and used to reduce the deficit. The Bundesbank reportedly earned \$300 million on dollar sales in the first two weeks of January alone. Most West German business and government leaders feel the advantages of the strong dollar outweigh the disadvantages. Bundesbank President Karl Otto Poehl is concerned, however, that further weakening of the DM could upset West German price stability. West German import prices rose 5 percent last year, primarily because of the weak DM.

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*Record Japanese
Trade Surplus*

Japan registered a record trade surplus in 1983, according to figures released by the Ministry of Finance on Tuesday. The trade surplus—led by booming exports and reduced oil imports—grew to a massive \$31.6 billion, and the current account surplus more than tripled to \$21.0 billion. The weak yen and a continued high savings rate caused a widening of the long-term capital deficit to \$17.8 billion, but Japan still recorded a \$3.2 billion basic balance surplus. The trade gap with the United States was \$18.1 billion.

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*Tokyo Approves Tight
Budget*

The Japanese Cabinet has approved a 50.6-trillion-yen (\$220 billion) budget for fiscal year 1984, which begins 1 April. Expenditures are up only 0.5 percent over the initial 1983 budget—the smallest increase since 1955 and a 2-percent real decline. Ministry of Finance officials lobbied hard for a tight budget to reduce persistent deficits:

- Defense spending is to rise by 6.6 percent, about the same as last year. The Ministry of Finance had proposed boosting the defense budget by 5.1 percent, but Prime Minister Nakasone has publicly stated he intervened to ensure the larger increase to fulfill a pledge to President Reagan.
- Foreign aid will rise by 9.7 percent. Most other categories show little change from last year. Public works spending—a mainstay of Japanese pork-barrel politics—will be cut by 2 percent.
- The central government deficit will amount to 25 percent of total spending, down slightly from last year. Increases in the corporate income tax and commodity taxes will nearly offset a personal income tax cut and a boost in the investment tax credit and other business allowances.

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The Finance Ministry remains concerned that the opposition parties' new strength in the Diet as a result of the December elections will lead to pressure on the government to loosen fiscal policy. Leaders of the two largest opposition parties, which have consistently advocated increased spending for social welfare programs, have already criticized the new budget, and their attacks

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will heat up after the Diet convenes on 6 February. Officials of the Economic Planning Agency and the Ministry of International Trade and Industry have also pressed for measures to stimulate domestic demand. A supplemental budget is likely to be passed later in the year, and the more free-spending Diet may use it to boost public works and other spending.

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*Japan's Complex
Memory Chip Lead
Strengthened*

A Japanese company, Toshiba, has announced the development of the most complex memory chip to date. The new chip, a 256K SRAM (static random access memory) has the equivalent of 1.6 million transistors—four times as many as the recently introduced 256K DRAM (dynamic random access memory) chip. The Toshiba chip uses complementary metal oxide semiconductor (CMOS) technology that offers significant performance advantages over present technology. Toshiba expects to send samples to its customers this year and begin large-scale production in 1985. The Toshiba announcement demonstrates the continuing Japanese lead in memory chips and in CMOS technology that has considerable potential for defense applications. Over the next few years, advanced memory chips such as the 256K SRAM and 1M (one megabit) DRAM are expected to be implemented in CMOS technology to attain high performance without excessive heat.

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*Fifth-Generation
Computer Prototype
Developed by
Mitsubishi*

Mitsubishi Electric Company recently announced it had succeeded in building a prototype fifth-generation computer hardware module termed "personal sequential inference machine" (PSI), to be used as a programming tool by the researchers at the Institute for New Generation Computer Technology (ICOT). This is the first product announcement of any kind since the Japanese fifth-generation program was inaugurated in 1981 and is likely to be the basis for a computer system to be marketed commercially by Mitsubishi. The system is reported to be as capable as a DEC 2060 mainframe computer in running the artificial intelligence language PROLOG. We believe that many of the fifth-generation computers' functions may be incorporated in the Mitsubishi prototype. According to K. Furukawa, chief of one of the ICOT research labs, Mitsubishi was chosen by MITI to develop the prototype to bring Mitsubishi closer to the main Japanese computer community (Hitachi and Fujitsu)

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*Japanese Bureaucracy
Clashes Over Software
Protection*

A report prepared for Japan's Cultural Affairs Agency (CAA), the Ministry of Education component responsible for administering copyrights, calls for extending copyright protection to computer software as in the United States and some European countries. The report sets the CAA on a collision course with the Ministry of International Trade and Industry (MITI), which is proposing to protect the rights of software developers through its own registration system rather than through copyrights. The MITI plan would include mandatory licensing modeled after the Patent Law, which gives the head of the Patent Agency authority to decide the terms for licensing a patent to others if the involved parties cannot negotiate an agreement privately. MITI's proposal apparently is intended to ensure Japanese manufacturers of

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IBM-compatible computers access to software that would be registered by IBM. Although the copyright protection favored by the CAA would last for 50 years, MITI would grant registered software only 15 years' protection from unauthorized use, according to Japanese press reports. Both CAA and MITI want to submit legislation to the current session of the Diet but appear to be too far apart to allow for early compromise.

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*Mitsubishi-Chrysler
Joint Production
Disclosed*

According to a recent Japanese press release, Mitsubishi Motors has reached a tentative agreement with Chrysler to jointly produce 200,000 subcompacts per year in the United States. Production is expected to begin by 1986 in either Chrysler's St. Louis or Belvidere, Illinois, plant. According to the article, 130,000 of the cars will be sold through Mitsubishi's independent dealers in the United States; the remaining 70,000 will be sold through Chrysler dealerships. The deal, which has been under negotiation for over a year, is expected to be completed this spring. Agreement between the two automakers may have been spurred by Mitsubishi's disappointment over their quota allotment assigned by MITI under the voluntary export restraint agreement.

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Less Developed Countries

*Saudi Arabian
Government Spending*

Saudi Arabia is avoiding politically risky spending cuts, despite reduced oil revenues and large deficits in both the budget and the foreign current account. The US Embassy reports that government spending shows no sign of falling below the budgeted \$75 billion for fiscal year 1984, which ends in April. The Saudis are taking only painless expense-cutting steps that include curtailing "nonessential" projects and reducing aid to non-Arab states. The government is continuing to provide funds for the petrochemical plants at Jubail and Yanbu; social programs, including food price subsidies; aid to Iraq; and the upgrading of air defense and other military capabilities. Last week the Saudis signed a \$4-5 billion deal with France for the Shahine surface-to-air missile system.

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The leadership is unwilling to make spending cuts that would cause public discontent. To finance deficits, Riyadh is relying on delayed payments and is drawing on its foreign exchange reserves. Some middle-level economic administrators, however, believe that the government has not gone nearly far enough in introducing austerity measures.

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*Bahraini
Overconfidence During
Hard Times*

Bahrain's recently announced two-year budget for 1984 and 1985 appears overoptimistic in projecting balanced budgets for both years. Manama expects a 13-percent increase in oil revenues from the Abu Safaa oilfield, operated for Bahrain by Saudi Arabia, and providing about half of Bahrain's total crude production. The US Embassy in Manama, however, is unaware of any Saudi agreement to increase output from the field, and oil prices are not expected to rise in 1984. Without increased oil revenues, Bahrain either will have to

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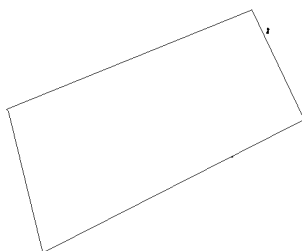
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undertake additional austerity measures or borrow to finance a budget deficit. Further spending cutbacks, however, could threaten political stability; two-thirds of the population are Shia Muslims heavily dependent on government spending. Spending cuts could make the Shias more susceptible to Iranian recruitment and subversion. Barring spending cuts, Bahrain probably will turn to Saudi Arabia and other Gulf states for assistance; these states also are troubled by lower oil receipts.

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*✓ Salvadoran GDP Flat
in 1983*



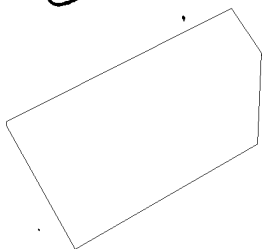
El Salvador's four-year economic decline appears to have been halted last year when real GDP roughly matched the 1982 level, according to the US Embassy. The leveling off reflected three main factors: rising output of corn and beans for domestic consumption; higher prices for export crops; and substantial US economic aid that helped manufacturers import key raw materials. Improvements in key sectors, however, are unlikely in 1984:

- Rising production of food staples is likely to be offset by falling harvests of key export crops—cotton and coffee.
- Exports of manufactures will be held in check by the depressed economic conditions in Salvador's traditional neighboring markets.
- The key banking sector will continue to struggle because about one-third of local bank loans to the private sector are in default.

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*✓ Chile Liberalizes
Mining Code*

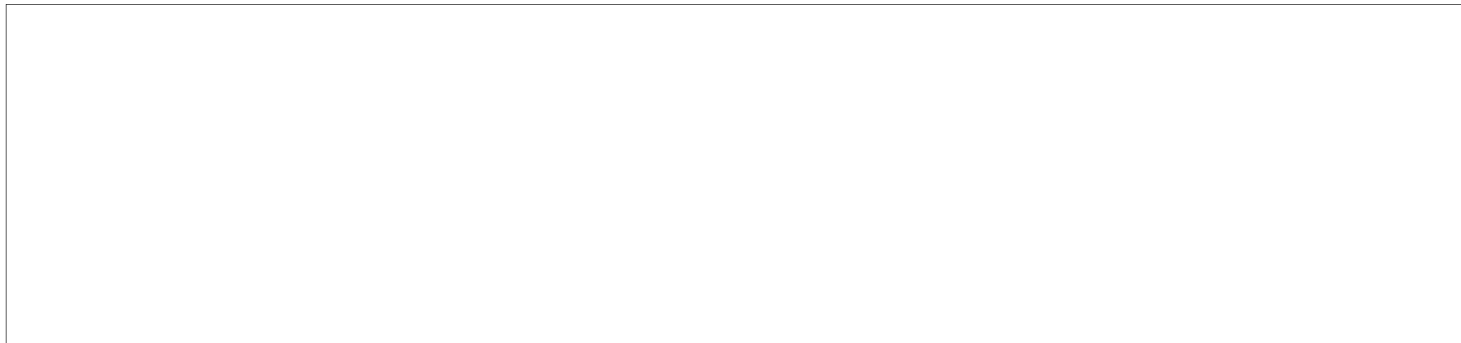


Chile recently enacted one of the most liberal mining codes in the Third World in an attempt to attract foreign investment and boost copper production. Chile earns nearly one-half of its export revenues from copper and possesses the world's largest reserve base. The new code gives foreigners equal rights with Chileans to buy and sell mineral concessions and puts the courts, rather than government agencies, in charge of awarding concessions. The law inhibits future takeovers by dramatically increasing the cost of expropriation and obliging the government to pay in advance; compensation would be based on the estimated value of minerals still in the ground rather than on the cost of existing investments. The guarantees are intended to reduce the risk of investing in Chile by prohibiting expropriations like those involving US copper mines in 1971. Despite the improved laws, world copper market conditions—depressed prices, inventories at five-year highs, and expectations for only modest growth in demand—suggest that large new copper investments are unlikely any time soon.

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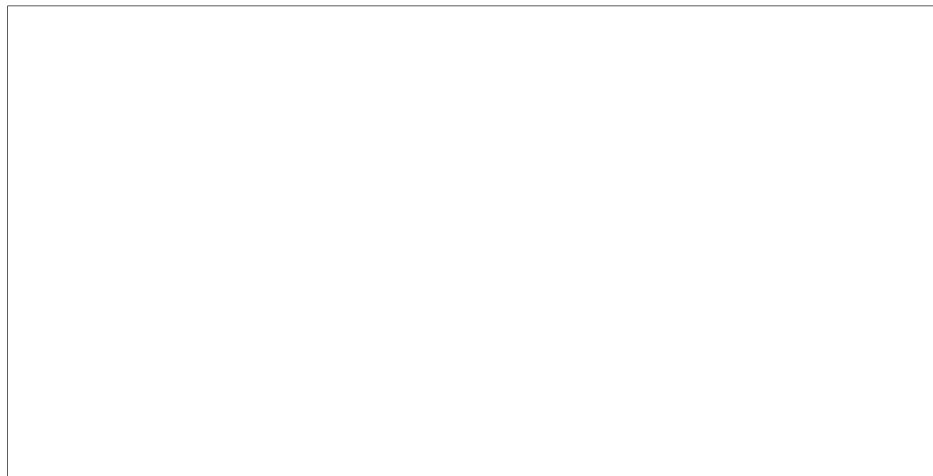
Communist



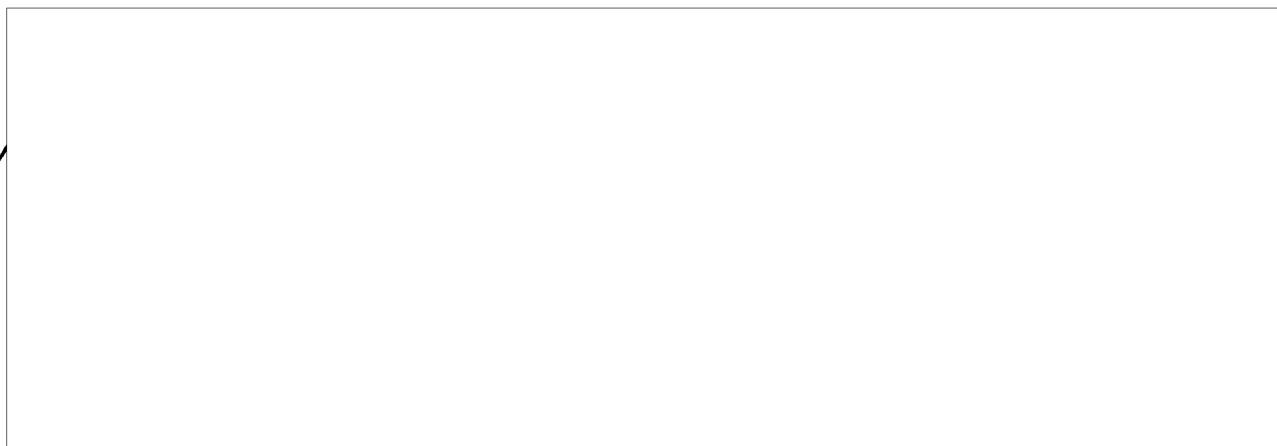
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*New CEMA Investment
Project*

Several East European countries have agreed to develop Soviet iron ore deposits in the first major CEMA joint investment project approved since the mid-1970s. A Romanian official has told the US Embassy in Moscow that Romania probably will join East Germany, Hungary, and Czechoslovakia in plans approved at the CEMA Council session in October for construction of the Krivorozhye iron ore combine in the Ukraine. The combine will cost the equivalent of an estimated \$3.6 billion and on completion in 1990 will produce 12.8 million metric tons of iron ore pellets annually. Under bilateral agreements to be concluded by June, the East Europeans will provide manpower, equipment, and possibly hard currency in exchange for future production. Czechoslovakia has announced that it will contribute the equivalent of \$493 million and will receive 1 million tons of ore annually from 1991 to 2000. Details on the other countries' participation are not available.

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Approval of this project reflects a renewed Soviet push for East European investments in return for deliveries of raw materials. In the past, such projects have been hindered by difficulties in reaching agreement on pricing and the amount of East European investments. The East Europeans are facing poor

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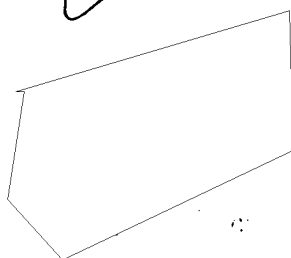
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prospects for trade with the West and a hard line from Moscow on future exports of oil and other raw materials. As a result, they probably now believe that they have little alternative to greater participation in Soviet resource development.

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*Cuban Consumers Get
Yearend Bonus*

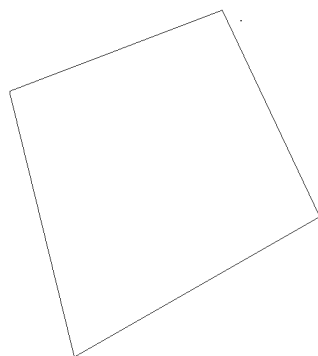


Cuban consumers were able to purchase an unusually wide variety of products from mid-December through the first of January, according to the US Interests Section in Havana. Apples were available for the first time in 10 years, chicken could be bought outside the ration system, and unrestricted quantities of pork—a Cuban favorite rarely available—were available at government markets. Dutch jams and canned cherries, as well as Romanian, Soviet, and Spanish wines, were widely available, although at high prices. This temporary easing of the normally austere lifestyle—which coincided with both the Christmas holidays and the 25th anniversary of the Revolution—probably was intended to offset repeated warnings that economic conditions will not improve in the near future. Since yearend, normal market conditions have returned.

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*Natural Disasters
Plague Tibetan
Economy*



China's Xizang Province (Tibet) was hit by natural disasters throughout 1983, stifling the economy and frustrating Beijing's efforts to make the province a showcase for minority development. Agricultural production, which accounts for about 90 percent of the province's output, probably declined in 1983 for the third straight year because of drought, livestock disease, insects, and a lack of inputs. Late last year Beijing described the area as suffering from the worst natural disasters in memory and instituted remedial steps. Beijing:

- Increased highway and air transport capacity to supply the province.
- Accelerated the distribution of relief grain.
- Increased budget allocations for disasters by 16.5 percent.
- Airlifted 100 metric tons of livestock fodder to the province.

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Beijing would like the province to become a model area to illustrate the leadership's concern for minorities and religious tolerance, to encourage the return of the self-exiled Dalai Lama, and to improve the central government's control over a remote but strategic region.

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Western Europe: Pressures on Welfare Spending and Implications for Defense

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The budgetary problems that most West European governments confront are due in large part to the huge increases in welfare spending that have occurred during the last two decades. Although there is widespread concern about budget deficits, public opinion strongly supports welfare spending and opposes tax increases. Nonetheless, a number of governments have begun to trim social programs, and we believe they will have to continue in this direction; welfare spending consumes so much of their budgets that they cannot solve their fiscal problems without making cuts in this area. The budgetary problems, coupled with public preference for social spending, make it unlikely that real defense outlays will increase significantly in most countries.

Pressures on the Welfare State

The West European welfare state has become far more than a social safety net assuring basic needs. Although the welfare state began by supplementing emergency assistance to the destitute with social insurance for industrial workers, it now also provides wide-ranging benefits to the middle and upper classes. Numerous universal health care programs; family allowances; student grants; and insurance schemes for the old, invalid, and sick attempt to assure a rough continuity of income for virtually all citizens.

In recent years, the costs of welfare programs have soared while state revenues have grown only modestly. According to the European Community, social welfare expenditures consumed an average of 27 percent of GDP in EC countries in 1981,

compared with 19 percent in 1970. An EC publication recently estimated that higher outlays for social benefits accounted for about one-half of the total rise in member governments' budgets between 1973 and 1982. During this period:

- Slow economic growth and high unemployment reduced the growth of tax revenues.
- High jobless rates also boosted unemployment compensation costs.
- Aging populations required added expenditures both for pensions and for health.

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In some ways, the welfare state is as much the cause as the victim of Western Europe's macroeconomic difficulties. Recent academic studies point out that large employers' taxes for unemployment, health, and disability insurance create a "wage gap" between workers' take-home salaries and their total cost to firms. By making labor more expensive to employers, the nonwage payments reduce the demand for labor and encourage automation. They also reduce business profits available for new investment, thereby contributing to slower growth.

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Government Responses So Far

The soaring costs of social welfare programs are forcing all of the West European governments to trim benefits in order to at least slow the rise of social spending. Certain governments are also challenging basic premises of the postwar welfare state. Although the Socialist-led governments in France and Italy are justifying ad hoc cuts as emergency measures to contain runaway budget deficits, the Governments of West Germany, the United Kingdom, and Denmark are questioning the principle of universal benefits. Leaders of the fiscally conservative governments in these countries contend that

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**Relative Costs to Governments
of Major Social Programs :
Specific Benefits by Type, 1980 ^a**

Percent of total social spending

	Belgium	Denmark	West Germany	France	Italy	Netherlands	United Kingdom
Total	100	100	100	100	100	100	100
Sickness	22	27	30	26	23	29	22
Invalidity-disability	8	9	6	5	20	0	9
Employment injury—occupational diseases	3	1	3	4	3	20	1
Old age	26	35	26	35	34	28	40
Survivors	12	1	15	7	10	5	2
Maternity	1	1	1	2	1	0	2
Family	12	10	8	13	7	9	11
Vocational guidance—mobility	2	1	3	0	0	0	0
Unemployment	10	12	4	7	2	6	9
Housing	NA	1	1	0	0	1	1
Miscellaneous	3	3	4	1	0	1	2

^a The West European welfare state utilizes a mix of cash payments and services in kind, supplemented by government decisions on tax credits, price subsidies, and the behavior of state-owned enterprises. West European governments administer wide-ranging health serv-

ices, housing, family allowances, old-age and disability pensions, and unemployment benefits. Funding methods vary widely among the countries and the specific programs but inevitably involve a major element of state subsidy.

the state should provide a social safety net for emergencies but that it should stop trying to guarantee full income maintenance. []

In northern Europe, Socialist opposition parties are attempting to exploit public hostility to cutbacks but have offered no clear alternatives for reducing budget deficits. In France, the Communists—who normally would be the strongest foes of welfare cuts—are restrained from being too vocal in their criticism by their participation in the Cabinet. In Italy, all five coalition parties have endorsed austerity in principle, but many of their deputies in Parliament are objecting to specific welfare cutbacks. []

Most governments are attempting to limit their budget deficits by taking a more parsimonious approach to defense spending, despite the fact that it accounts for a far smaller percentage of their countries' budgets. Last year, for example, only

four European allies—the United Kingdom, Luxembourg, Norway, and the Netherlands—came close to meeting NATO's target of a 3-percent real increase in military spending. In most of the other countries, real military spending probably increased only marginally. In France, defense spending stagnated and may actually decline in real terms in 1984. []

Public Opinion and the Welfare State

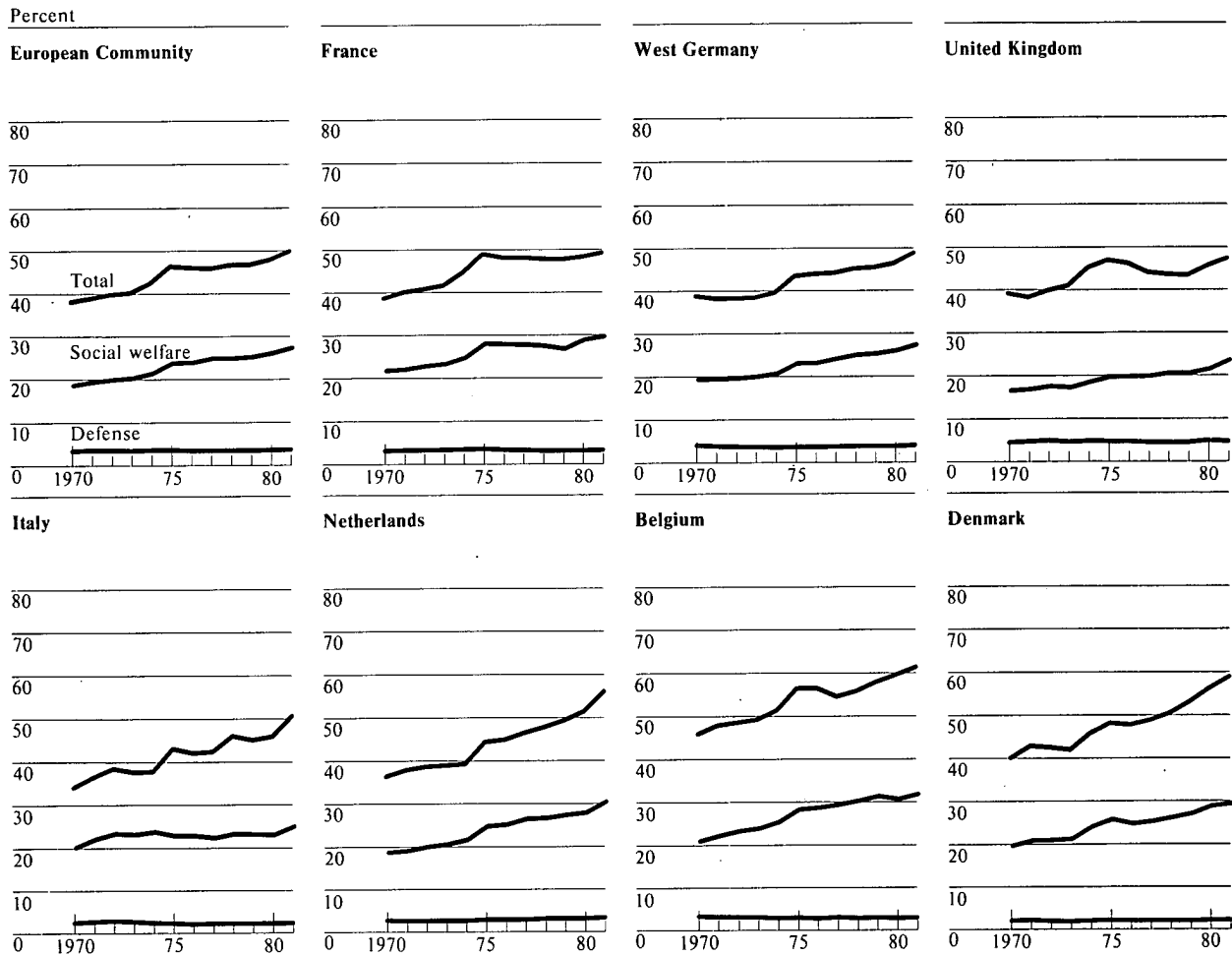
Polling data, although scattered and often fragmentary, indicate widespread support for social programs, skepticism about defense spending, and strong opposition to tax increases. In a 1982 EC-sponsored poll that asked what causes were sufficiently important to inspire sacrifices, 40 percent named the struggle against poverty—a cause that

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General Government Spending as a Percentage of GDP



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ranked behind only peace and human rights. By contrast, only 23 percent named national defense.

A large majority of West Europeans oppose reductions in social spending. In most cases, even high-

income respondents and right-of-center voters tend to reject welfare reductions:

- In a French poll published last July, 58 percent said the health budget must cover health needs regardless of how national wealth changes.

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- In a Dutch poll conducted last April, two-thirds of the respondents opposed any reductions in social benefits.

In contrast, West Europeans are not supportive of military spending. A poll in April 1982 found pluralities opposed to defense spending increases in France, West Germany, Italy, and the Netherlands. A plurality of Britons favored increases, probably in reaction to the Falklands conflict. In a July 1983 Gallup survey, however, almost half the Britons polled said defense spending was too high, while only 12 percent said it was too low.

Further tax increases are even more unpopular than social spending cuts in most West European countries for which polling data are available. Various 1983 surveys in Italy, France, West Germany, Belgium, Denmark, and the Netherlands found that opposition to tax hikes was even more widespread and intense than opposition to welfare reductions. In British Gallup surveys conducted from 1979 through 1983, by contrast, about one-half of the respondents favored increased social welfare programs even at the cost of higher taxes—a sentiment reflecting, in our view, widespread dissatisfaction with Prime Minister Thatcher's economic policies.

Prospects for Retrenchment

We expect the strains on social welfare budgets to continue throughout the 1980s.

Western Europe's already high unemployment rates are likely to increase still more in the next several years, primarily because demographic trends will add even more prospective workers to the labor force than in the 1970s and because wage costs almost certainly will not moderate sufficiently to create enough new jobs. In addition, most economists expect the recovery in Western Europe to be much less robust than those following previous recessions, which means that job creation will be slower and that government tax revenues will increase less rapidly than during past recoveries.

Furthermore, the costs of health care and old-age pensions will grow as the number of elderly and retired persons increases.

Despite the political risks of cutting welfare, we believe West European governments have no other choice. Social programs consume such a large share of public budgets that austerity limited to other areas is unlikely to solve government financial problems. Some governments will probably try to raise new revenues. Taxes, however, are already high in most West European countries, and substantial increases could impede economic growth and provoke stiff political resistance.

Because of growing numbers of pensioners and continuing high unemployment, West European governments probably will not be able to reduce their welfare budgets, but they should be able to slow the rate of growth. Even conservative governments are unlikely to challenge basic structures of the welfare state. In making program cuts, most governments, in our view, will emphasize the welfare state's function as a social safety net and chip away at the practice of universal coverage. West Germany, the United Kingdom, Denmark, Belgium, and the Netherlands will probably tighten eligibility requirements for many social benefits. These countries are also likely to limit cost-of-living adjustments in income transfers and make greater use of means tests for public assistance.

Impact on the United States

In our judgment, the continuing need to trim social welfare spending will prevent significant military spending increases in most West European countries and could even lead to selective cuts. Although defense expenditures account for only a small proportion of West European public budgets, most governments are sensitive to the linkage between defense and social welfare spending in the public mind. They will thus be loath to promote defense increases while being parsimonious in other areas.

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Even Prime Minister Thatcher, who enjoys a solid parliamentary majority and does not need to call elections before 1988, is facing growing difficulties in maintaining planned increases in the military budget. Most other West European governments, which have had an uneven record of meeting NATO's goal of a 3-percent real yearly increase in defense spending, are unlikely even to approach that goal in the next several years.

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Slow growth in military spending will probably delay or eliminate planned equipment modernization programs and may decrease the West European countries' overall military capabilities. Because of high inflation in the defense sector and the growing sophistication of modern weapons, even real 3-percent yearly increases in military budgets would probably be insufficient to maintain current forces and to fund planned modernization programs. Continued stagnation in West European military spending could force significant cutbacks in military readiness, including personnel reductions, shortened training periods, slowdowns in weapons procurement, and cancellation of new weapons purchases.

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France: Options on Austerity

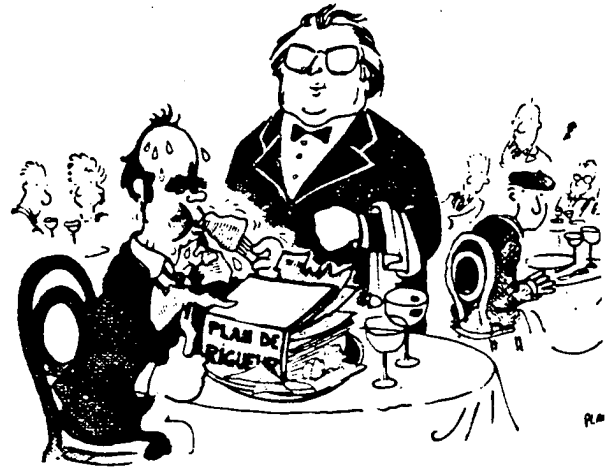
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Despite rising labor resistance, the French Government appears determined to give industrial modernization and the battle against inflation priority in 1984. Continuing such policies beyond early 1985, as may be warranted by economic conditions, will be politically risky for President Francois Mitterrand and is likely to cost Mitterrand's coalition support from the left in the 1986 legislative elections. He thus may attempt to shift his political base toward the center.

Austerity—The First Fruits

Rising inflation and a soaring current account deficit forced the Mitterrand government to abandon expansionary policies and shift to austerity in 1982. This shift was reinforced last March with a new austerity package and the ouster of a leftist spokesman in a cabinet reshuffle. These changes signaled a smaller role for the government in the daily running of the economy and an increased recognition of the cost of supporting sick industries. The government now acknowledges the need for profitability, even at the cost of cutting back work forces. The decision in late 1983 to allow Peugeot to reduce its work force by nearly 2,000 workers—despite strong union opposition—was the first significant indication the government was willing to allow some loss of jobs in order to promote modernization.

The austerity measures adopted by the Socialist government over the past 18 months have yielded mixed results. The trade deficit last year was about \$6 billion compared with \$14 billion in 1982. The current account improved by \$8 billion last year as well but still recorded a \$4 billion deficit. At the same time, prices, measured from December to December, rose 9.3 percent, well above the 8-percent target. Real GDP recorded only a slight increase last year—after growing by 2 percent in



French Prime Minister Pierre Mauroy serves up the austerity plan to Georges Marchais, the head of the Communist Party.

Le Monde ©

1982—and probably will not do better in 1984. Consumption spending fell in the third quarter of 1983 and may continue to decline through the first half of 1984. Exports, which have expanded rapidly since the devaluation in March 1983, probably will again be the major source of any growth.

Austerity—Continuing in 1984

Having made some progress thus far, the government seems fully committed to continuing austerity for another year:

- The 1984 budget maintains about the same degree of austerity as the March 1983 package, but the money-supply target (M2) has been cut by 3 percentage points to only 6 percent.
- Price controls are scheduled to be eased only as inflation slows. The government hopes that price controls, wage guidelines, and a tough position in

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negotiations with government workers will hold down wage increases.

- Paris hopes to slow inflation to 5 percent this year, which would be the lowest rate since 1970.
- The government expects progress on the foreign payments front to continue and hopes the current account will achieve a surplus in 1985—perhaps \$6-7 billion—in order to reduce France's medium- and long-term foreign debt, which now totals \$53 billion.

The improvement in trade and current account balances may allow Paris to delay another devaluation of the franc, which many forecasters had predicted for this spring. The continuing strength of the dollar, though much maligned by the French, also will reduce the probability of a franc-mark realignment in the near term. Stronger growth among the other industrial countries bodes well for the foreign balances and the franc for the first half of the year.

On the other hand, French inflation probably will continue to exceed that of most competitor countries in 1984, hurting French competitiveness. In addition, reduced OPEC income and LDC debt problems have weakened demand for French products in traditionally strong markets. Moreover, interest payments on France's foreign debt will be higher this year. Given these factors, Paris is not ready to declare victory on the foreign payments front.

We believe the most agonizing challenge the French will face this year will be the management of structural change. The government could be called on to authorize a quarter of a million layoffs in 1984; job losses are likely to be particularly serious in coal, steel, shipbuilding, and textiles. Mitterrand's leftist coalition will find this ideologically and politically difficult and will be vulnerable to attacks by labor and the Communists.

Austerity—When Will It End?

In our judgement, the French will not fully achieve their economic objectives in 1984. We expect the French to exceed their 1984 inflation target by 2 to 3 percentage points and to have one of the highest inflation rates among the major industrial countries. Although the current account is likely to improve through 1984, the anticipated 1985 surplus will not be sufficient to allow a rapid reduction in French debt. The structural problems of the French economy will remain, and unemployment could rise about 0.5 percentage point to 9.5 percent by year-end.

By early 1985, even with austerity goals only partially achieved, the Socialists will turn their attention toward the National Assembly elections scheduled in the spring of 1986. Conventional wisdom and previous Socialist strategy statements indicate that the Socialists will feel obliged to stimulate the economy to improve their bleak election prospects. The Mitterrand government knows such a reversal would be risky for the economy. The previous Socialist expansion program in 1981-82 caused a rapid increase in imports and only a modest improvement in domestic conditions. Mitterrand and his advisers are painfully aware how rapidly the current account can deteriorate and the franc weaken and thus may consider an alternative policy.

Political Implications

President Mitterrand has basically three options:

- To move to the right and continue austerity through 1985 and perhaps beyond, accepting an increase in unemployment as the cost of modernization.
- To maintain the current policy of austerity for this year and then stimulate the economy in 1985 in the hope that an upturn will help Socialist candidates.

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- To swing to the left and adopt Communist and leftwing Socialist proposals to head off rising unemployment with immediate stimulative and protectionist measures—an alternative he has already rejected twice. [redacted]

Mitterrand appears to be leaning toward the first option. In recent speeches both he and his loyal lieutenant, Laurent Fabius, the Minister of Industry and Research, have stressed the importance of pressing ahead with modernization. The government's handling of the Peugeot strike suggests that Mitterrand is willing to accept the political risks of reducing the number of workers in the troubled smokestack industries. [redacted]

[redacted]

Mitterrand probably hopes that political gains in the center will compensate for the likelihood that the left will lose its legislative majority in 1986. By restoring economic health and showing that modernization holds future promise, he will be in a position to court support from centrist voters who were crucial to his victory in 1981 but who are now disenchanted with the government's economic management. Such a move to the center may be part of a broader strategy, suggested by several French political commentators, in which Mitterrand might propose a system of proportional representation to strengthen centrist parties prior to the 1986 elections. [redacted]

A move to the center and the continuation of austerity are not without risks. Mitterrand's uneasy alliance with the Communists almost certainly would end. The break could occur through Mitterrand's forcing them out of the Cabinet if they refuse to support his policies, or the Communists

could leave on their own and attempt to portray themselves as the "true" defenders of labor. The Socialists could end up as an isolated minority if the leftist coalition breaks up before Mitterrand cements his ties to the center. Rising protests against austerity, however, might become so strong that he would be forced to abandon the policy before it achieved its goals. [redacted]

There will be a number of signposts in 1984 that will indicate whether Mitterrand has indeed decided to attempt a shift toward the center. The first will be the determination with which the government pursues its goal of modernization and its willingness to accept the dismissal of large numbers of workers in sectors such as coal, steel, and shipbuilding. Next will be the nature of the Cabinet shakeup that is widely anticipated in the second half of 1984. Prime Minister Pierre Mauroy, who is closely identified with the policy of protecting jobs, may be replaced, and the political coloration of his successor will say much about the government's intentions. A Cabinet shuffle could also provide the occasion for a showdown with the Communists. Finally, the 1985 budget, which will be introduced next autumn, will indicate the intensity with which Mitterrand has decided to continue with austerity.

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Lebanon: Economic Impact of Continuing Hostilities

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The normal resilience of the Lebanese economy is being sorely tested by nearly a year of sustained violence. Disruption in agriculture and commerce combined with transportation difficulties and partial Arab boycotts have cut drastically into export earnings. The declining confidence of wealthy Christian and Sunni Muslim businessmen in the prospects for stability in Lebanon and the recent evacuation of many Palestinians have sharply reduced remittances, giving Lebanon its first payments deficit in memory.

Iraq's financial problems and the partial boycott of Lebanese goods by Saudi Arabia; these two countries took over 40 percent of Lebanon's exports in 1982. The Iraqi market for Lebanese goods virtually disappeared last year because of Baghdad's foreign exchange shortfalls. At the same time, Saudi Arabian officials, apprehensive over the prospect of Israeli goods penetrating their market disguised as Lebanese products, cut their purchases by almost 15 percent in the first nine months of 1983, according to US Embassy reports.

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Moreover, the efforts of President Gemayel's government to expand its authority through the use of the Lebanese Armed Forces is putting tremendous strains on the government treasury at a time when the limits to government control are hampering revenue collection. It is unlikely, at least in the near term, that the Gemayel government will be able to deal effectively with its economic problems or stem the decline in confidence.

Lebanon has previously been able to count on remittances to offset its trade deficits, but these, too, have fallen victim to the continuing strife. In 1982 repatriations from the estimated 250,000 Lebanese and Palestinians working abroad and funds being transferred directly to the PLO amounted to \$150-200 million per month. From discussions with local banking sources, the US Embassy estimates that those remittances have fallen by one-half. In particular, bankers estimate that \$50 million per month was flowing into Tripoli before the PLO evacuation; these funds have probably dried up.

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Central Government Financial Problems

Emerging Foreign Payments Problems. Beirut has traditionally incurred large trade deficits because exports—primarily to Arab markets—normally cover only 30 percent of the import bill. Last year exports, by our calculations, fell by almost 50 percent to about \$450 million after declining 32 percent in 1982. We estimate that imports of vital food, fuel, industrial goods, and military equipment only declined about 10 percent to \$2.8 billion

As a result of the decline in remittances as well as likely shortfalls in other service earnings—including transit fees and flows to the banking sector—Lebanon probably incurred a payments deficit for the first time in memory. During January-November 1983 foreign reserves had declined by about \$700 million.

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The primary causes for the poor showing of exports are threefold. Transportation dislocations, particularly those associated with security problems along the Beirut-Damascus highway, have cut vital overland linkages with Lebanon's traditional Arab markets. Equally important have been the effects of

The Budget. The drop in the level of trade and port collections and haphazard tax collection have sharply reduced central government revenues. Although the Gemayel government did manage to extend its authority over two illegal ports early in

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1983, falling imports caused customs collections to decline about 36 percent below government projections, while expenditures associated with the military kept the budget deficit above \$1 billion.

Government budget plans for 1984 probably will prove unrealistic, and the budget deficit is likely to rise sharply. Revenues are projected to increase by an unlikely 40 percent to \$1.4 billion while expenditures are to grow by only 23 percent to \$2.1 billion. Allocations to the military are targeted to comprise almost 20 percent of total budgeted expenditures, but these figures do not include the costs of additional ammunition and hardware that military observers believe are needed. Embassy sources estimate that such additions would require \$440 million above currently budgeted figures.

Domestic Impact

While Beirut tries to cope with difficult financial problems, everyday economic existence for the business community and for the Lebanese citizenry is becoming more difficult. Activity in the trade and services sectors has dropped off considerably, resulting in slowly rising unemployment. According to Embassy reporting, almost 150 workshops and small factories in the southern suburbs of Beirut have shut down completely, while many larger firms producing consumer goods both for export and local consumption are operating well below capacity. Between 20 and 30 percent of the domestic labor force totaling 600,000 are believed to be out of work or underemployed. Economic slowdowns in the oil-producing countries have probably stemmed the flow of new migrants to jobs in the Gulf. Although the extended family system in Lebanon has cushioned the impact of growing unemployment, further dislocations could provide additional sources of recruitment for the various confessional militias and radical groups currently existing in Lebanon.

Widespread layoffs in the services sector have not yet surfaced, but the potential is growing. With remittances down and investment activity virtually halted, many of the smaller family-run banks are

overextended and teetering on the brink of insolvency. For the larger banks that are still fairly liquid, the only investment outlet remaining is government treasury bills; private bankers, who already hold two-thirds of Lebanon's public debt, are reluctant to invest too large a percentage of their capital in the Gemayel government. Shipping and insurance firms are weak because of the low level of trade activity.

Trans-Arabian Pipeline Company (TAPLINE) closed its Beirut offices at the end of 1983 and formally turned over terminal and storage facilities to the Lebanese Government. According to Embassy sources, TAPLINE's decision stemmed from losses accumulated since 1975, war-related damages to company installations, and continuing uncertainty about the future.

Deteriorating infrastructure problems are compounding the economic downturn. Damaged electrical lines have resulted in both electricity and water rationing in Beirut. To cope, resourceful Beirut citizens have reportedly set up individual generators and have been illegally tapping into water mains. So far, however, damage to the country's main oil installation at Tripoli—incurred during heavy fighting between Palestinian groups in early November—has not resulted in fuel rationing, because of supplies from a small storage facility near Beirut. The possibility of fuel rationing will remain as long as the Tripoli installation is out of commission—estimates of repair time range from three months to a year—and fuel shipments from the Sidon facility behind Israeli lines remain problematic.

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The Depressed South

Israeli actions have effectively cordoned off the area south of the Awwali River and continue to depress the south's primarily agricultural economy. According to Embassy reporting, agricultural food prices in the south increased by about 12 percent in November as orchards and farmlands were bulldozed by Israeli Defense Forces (IDF) for security reasons. According to local businessmen, the IDF continues to limit access to the port at Sidon to certain favored shippers, making it difficult to move agricultural produce to regional markets, while the Syrian occupation restricts overland shipments to Arab countries. Moreover, detours and Israeli checkpoints continue to hamper food and fuel shipments to and from Beirut. Embassy officers have observed as many as 100 trucks parked on the shoulder of the road waiting to cross the river in the course of one day; such long waits often result in truckloads of spoiled produce. [redacted]

Prospects Dim, But . . .

Although the Lebanese economy has proved amazingly resilient through almost 10 years of hostilities, last year's nonstop conflict seems to have taken a psychological toll on Lebanese confidence. Recent Embassy reporting indicates that Sami Marun, head of the Economic Council for External Relations and a prominent Christian businessman, is now expressing increasing concern about the state of the Lebanese economy. [redacted]

[redacted] business confidence is being shaken by the fact that Foreign Minister Elie Salim is temporarily acting as Minister of Finance and has little time to devote to economic concerns. In our judgment, should the current political-military situation continue, the government's attention will be further diverted from economic problems, and the Lebanese economy will deteriorate. [redacted]

Should a cease-fire eventually take hold or should the Israelis pull out of southern Lebanon—as appears increasingly likely—the economic situation

would substantially improve. Several factors contribute to this cautious optimism:

- Although there has been a spate of Lebanese pound-to-dollar conversions—contributing to a 20-percent decline in the value of the pound since the end of 1982—[redacted] most of these funds are still being held in Lebanon. 25X1
- The continued high liquidity of many of the larger banks indicates that investment funds would be available to rebuild, should a period of relative calm occur.
- An Israeli withdrawal—at least to below the agricultural growing areas in the south—would allow a partial recovery in agricultural trade and would ameliorate domestic fuel and food supply problems. 25X1
- Lebanon's foreign debt is still very small—about \$400 million. 25X1

Lebanese workers and businessmen remain the country's most productive resources, and any cessation of fighting is likely to prompt the same type of rebuilding effort that has occurred on numerous previous occasions. [redacted] 25X1

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Iran: Trade Boom Masks Domestic Breakdowns

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Bureaucratic mismanagement, war-related disruptions, massive corruption, and ideological rigidities have stifled the Iranian economy despite a strong oil export performance over the last two years. Much of Tehran's new oil money is being used for imports to replace lost domestic production and thus shore up living standards for the war weary and increasingly cynical populace. Until current conditions are alleviated, Iranian economic prospects remain dismal.

Revived Oil Exports

In response to declining revenues and the need to finance its war with Iraq, Tehran in early 1982 belatedly reduced its oil prices to bring them into line with the rest of OPEC.

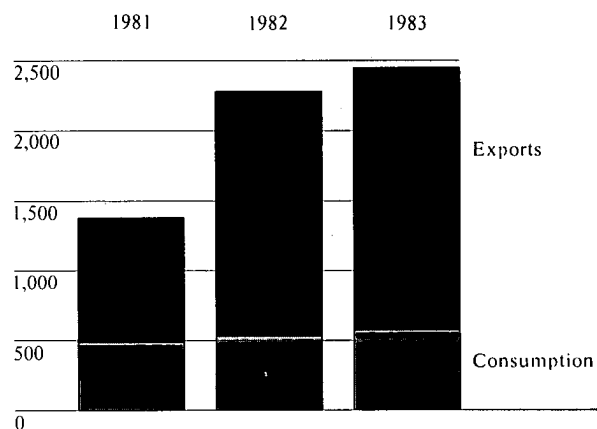
Iran exported nearly 1.9 million b/d of oil during 1983, compared with about 1.7 million b/d in 1982 and 900,000 b/d in 1981. The 1-million-b/d increase since 1981 represents about \$9 billion in yearly oil revenues at current oil prices. Since early 1982 the regime has quietly pursued its goal of raising oil exports with the help of discounting and barter deals:

- Tehran reportedly has signed 1984 contracts for up to 1.1 million b/d at spot market prices. Spot prices have firmed since the signings but are still \$0.10 below official Iranian prices and are expected to remain weak throughout the year. Iran reportedly eased other terms of sale.

- the Iranians are valuing their oil in barter trade deals at \$24-26 per barrel.

Iran: Crude Oil Production

Thousand b/d



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Nonoil exports are negligible as a result of the disrupted economy and the overvalued rial. The rial currently is trading as high as 450 to the dollar, but officially is pegged at about 85 per dollar.

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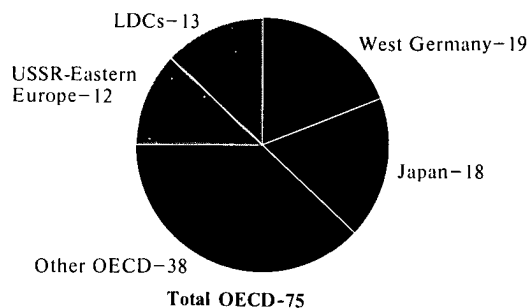
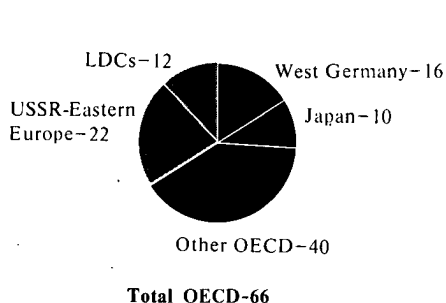
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DI IEEW 84-005
3 February 1984

Secret**Iran: Non-barter Imports, 1982-83**

Percent

1982: US \$ 9.0 billion^a1983: US \$ 15.6 billion^a^a Estimated.

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Imports Surge

Tehran stepped up nonbarter imports by 75 percent during 1983, to a level of about \$16 billion, according to our estimates based on international trade data. In addition, some \$4 billion worth of oil was also traded directly for goods—largely arms from Syria, North Korea, and East European countries.

All categories of imports showed large gains as the government attempted to compensate for domestic shortfalls. Foodstuffs imports have nearly tripled since 1978, partly the result of rapid migration into the cities but also a reflection of Tehran's failed agricultural policies. Open source data indicate that Japan and West Germany picked up about one-half of the overall increase in Iranian trade and about 60 percent of the increase in trade with developed countries. Total imports now exceed the \$17 billion level reached immediately prior to the revolution.

Domestic Situation

Iran's internal economic situation stands in stark contrast to the orderly and prosperous image conveyed to the outside world by its external accounts and booming trade during 1983.

consumers queue up daily in Tehran and other major cities to purchase subsidized foodstuffs despite their extremely low quality. At the same time, there is plenty of food and other necessities—even luxuries—for customers willing or able to pay four times or more government-controlled prices. Much of the former middle class is subsisting only by selling off assets such as real estate, automobiles, or rugs. The regime—for a price—turns a blind eye on free-market trade in food and consumer goods, which has helped to refocus consumer resentment away from the regime to the bazaars,

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Migration to the cities has strained basic services. Tehran still experiences scheduled daily power outages and other interruptions in power service, in part because of widespread illegal tap-ins to the power distribution network. Frequent water-supply interruptions reportedly occur in Tehran and other major cities, and water filtration and chemical treatment facilities in at least two major cities have been out of service for some time. []

Iranian public health reportedly has deteriorated seriously:

- Diseases such as malaria, diphtheria, typhus, and meningitis have reappeared—in some areas in epidemic proportions.
- No laboratories or regional disease control posts are operating.
- Trash removal services have broken down in some cities, and pesticides are in extremely short supply.
- Iranian physicians have emigrated, been pressed into military service, or often been barred from practice by the regime for their political views. []

Economic activity is being disrupted by:

- Chronic shortages of skilled personnel—particularly managers.
- Inefficiencies and disincentives due to Islamicization, arbitrary government decisionmaking, and confiscatory social welfare and other taxes.
- Disrupted conditions in higher education and agriculture.
- Worse-than-ever corruption.
- The war, which takes precedence over civilian needs, particularly in the beleaguered transportation and distribution sectors. []

Tehran's patronage system ensures that the regime's adherents—or friends and relatives of those in power—are placed in key administrative and managerial positions despite an absence of qualifications. Others are given nonproductive positions to monitor religious and political conformity:

- The chief executive of the regime's Foundation for the Oppressed, a multibillion-dollar conglomerate of commercial and industrial enterprises, reportedly is a former hardware salesman backed

by the clergy. He recently appointed his brother-in-law, a former pickup truck driver, as one of his two deputies. The Foundation earned less than 0.1-percent profit on its \$15 billion-plus holdings and during 1983 expropriated more than 1,500 businesses—many of which had failed, []

- Exile radiobroadcasts claim the Revolutionary Guards are packing the Commerce Ministry. The Revolutionary Guards, who have used their police powers for extortion purposes, are perceived by many Iranians as poorly educated, lower class villagers, who in prerevolution times would have trouble getting jobs as common laborers.
- The Tehran Electricity Board reportedly employs several hundred *Hezbollahis*—toughs payrolled by the regime to maintain order at Friday prayer rallies and to quell disturbances. []

Few qualified individuals are willing to step forward and take full responsibility for managing government programs or state-owned enterprises because they do not have the authority to make even the most needed changes. Several Iranian leaders have publicly acknowledged the regime's limited ability to cope with production, allocation, and distribution decisions and the dangers of growing centralization and government control over the economy. []

Agriculture

The Khomeini regime has managed to create a shambles out of the already inefficient agricultural system it inherited from the Shah:

- Incentives to invest or plant have been destroyed by controlled government prices and shortages of fertilizer, pesticides, and machinery.
- Most breeding stock has been slaughtered for current consumption because of feed shortages.
- Many of the larger, more efficient farms have been occupied by squatters since the revolution. []

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In the remote areas of the country, agricultural problems abound. In Fars Province, local Revolutionary Guards have conspired with mullahs from Qom to bring landowners before revolutionary courts on trumped-up charges and sentence them to forfeit their land, [redacted] In Khorasan, major crop losses were expected during 1983 as a result of the combination of a declining water table—a serious problem throughout Iran—and shortages of irrigation pumps. Since early 1982, electrical power shortages and fluctuations have burned out most electrical pumps, and diesel fuel for mechanical pumps generally has been unavailable, probably because of war needs and earlier damage to refineries. New pumps, engines, and spare parts are virtually unobtainable. The regime's disrupted distribution system generally does not extend much beyond the major cities. [redacted]

Industry

Iranian industrial output is running at 40 to 60 percent of the prerevolution level, according to various observers. Open source economic reporting indicates that major petrochemicals, iron and steel, and other industrial facilities are producing little or are effectively abandoned. In January of this year, an Iranian official noted that the government was able to allocate only \$4 billion of the \$6 billion in foreign exchange needed during 1983 to supply industry with raw materials and spare parts. Despite the idle capacity, government planners insist on devoting more than 50 percent of available investment funds to the industrial sector, mostly to complete projects, similar to those now idled, held over from the Shah's period. [redacted]

Outlook

There is little to suggest a significant improvement soon in the regime's economic performance, and an end to the war with Iraq will not necessarily bring relief. Competition in a weak oil market from other suppliers strapped for cash will impede Tehran's attempts to increase oil exports by shaving prices. If the war ended, Tehran probably would face increased competition from Iraqi oil exports. [redacted]

Iran's longer term prospects will depend largely on improved economic management and the level of foreign participation Tehran is willing to tolerate and can afford. The regime has not yet demonstrated a coherent vision of how to organize the Iranian economy. Tehran's internal disagreements and its claims that the establishment of the Islamic Republic—and indeed its policies—are divinely ordained, make the leadership slow to come to grips with the economic problems they have created. Instead, Tehran looks for scapegoats when things go wrong. [redacted]

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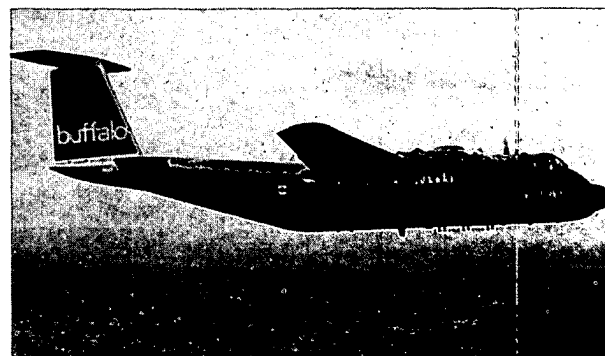
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Canada's Aerospace Industry: A Troubled Future

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Canada's aerospace industry is counting on the government to continue covering its losses during the present slump and to increase other forms of support in the future. The government's aerospace task force recommended increased export financing—a vital aspect of the sale of aircraft abroad—and additional federal aid for research and development to improve Canada's position in the world aerospace market. We believe that Ottawa will step up its support for the aerospace sector, but we doubt that its goal of doubling sales by 1987 can be realized.



De Havilland Buffalo military and civilian transport, sold primarily to Third World air forces

Flight International ©

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Space

About 50 firms are involved in Canada's space industry, with the public and private sectors employing approximately 3,000 of Canada's most highly skilled workers. Sales grew rapidly during the past decade, and, in 1982, 62 percent of Canada's space-related production was exported. Spar Aerospace, Canada's largest space firm, is a leader in the design of remote manipulation equipment, as demonstrated by the successful use of the Canadarm during recent space shuttle flights.

Canada was a pioneer in communication satellite design and manufacture. Spar Aerospace has contributed to the design and manufacture of 50 communication satellites and subsystems including the Canadian Anik A, B, C, and D. Spar recently won a \$135 million contract for a Brazilian satellite system and a \$130 million contract with Nigeria, with the US company Hughes Aircraft as a major subcontractor.

Structure of the Industry

Canada is the fifth-largest non-Communist producer of aerospace equipment and has held 2 to 3 percent of the world market since 1960. Over the past two decades, Canada's aircraft industry has evolved from inward-looking firms predominantly involved in military subcontracts to export-oriented producers, primarily of commercial commuter aircraft. Despite the limited size of the industry, Canada has gained an international reputation as a leading manufacturer of such diverse products as short takeoff and landing (STOL) aircraft, small engines, simulators, and unmanned surveillance drones. It is also an important manufacturer of space products, particularly communication satellites. In addition, Ottawa hopes to capture a large share of the helicopter market with a new production facility in Montreal.

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Highly integrated with the US aircraft industry, Canada's aerospace sector is led by the two government-owned airframe manufacturers—Canadair

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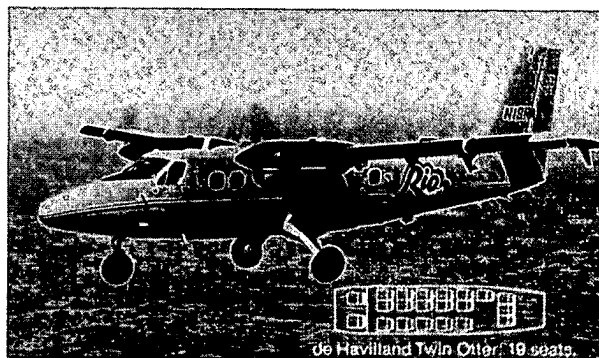
Structure of Canada's Aircraft Industry

<i>First tier</i> (4 companies)	<i>Complete aircraft and aeroengine design and manufacture:</i> <ul style="list-style-type: none"> • Canadair produces general aircraft and subcontracts for the US military and commercial industries. • De Havilland produces for the short-haul commuter market. • Pratt and Whitney Canada holds 17 percent of the world small airplane engine market and 60 percent of the gas turbine market. • Bell Textron will begin the production of helicopters in 1985.
<i>Second tier</i> (approximately 20 companies)	<i>Component producers with some design and development capabilities:</i> <ul style="list-style-type: none"> • The largest of these companies include Bristol Aerospace, Litton Systems, Spar Aerospace, Computing Devices, and CAE Electronics. Most companies are foreign owned.
<i>Third tier</i> (approximately 100 companies)	<i>Provides specialized industry services, and many have nonaerospace activities. These are mostly small, domestic-owned companies.</i>

and de Havilland. About 120 smaller companies provide subsystems, components, and services. Nearly 80 percent of production is exported, with two-thirds of the exports going to the United States. Although Canada is a net exporter of aerospace equipment, it imports a large number of products. Both the industry and Ottawa support free trade with the United States in this sector. According to press reports, Ottawa perceives a growing trend toward protectionism in the United States and fears that measures will be implemented that would restrict Canada's access to the US market.

Employment in the Canadian aerospace industry dropped sharply during the recession and is now approximately 36,000—about 3 percent of total manufacturing employment. Five percent of those employed in the industry are scientists or engineers, making it the premier high-technology sector.

The regional economic and political impact of subcontracting and procurement decisions in the aerospace industry often plays a major role in government investment decisions. For example, Canadian subcontract work for the US-produced F-18



De Havilland Twin Otter STOL aircraft, probably Canada's most successful aircraft

Flight International ©

fighters was split 48 percent to Quebec, 40 percent to Ontario, and 12 percent to other provinces under the original agreement. Quebec companies, however, have expressed concern that Ontario is actually getting a much larger share of the F-18 work.

to offset this criticism—and boost Liberal election chances in Quebec—Ottawa mandated that the new helicopter plant be located in Montreal, even though the company preferred the Toronto area.

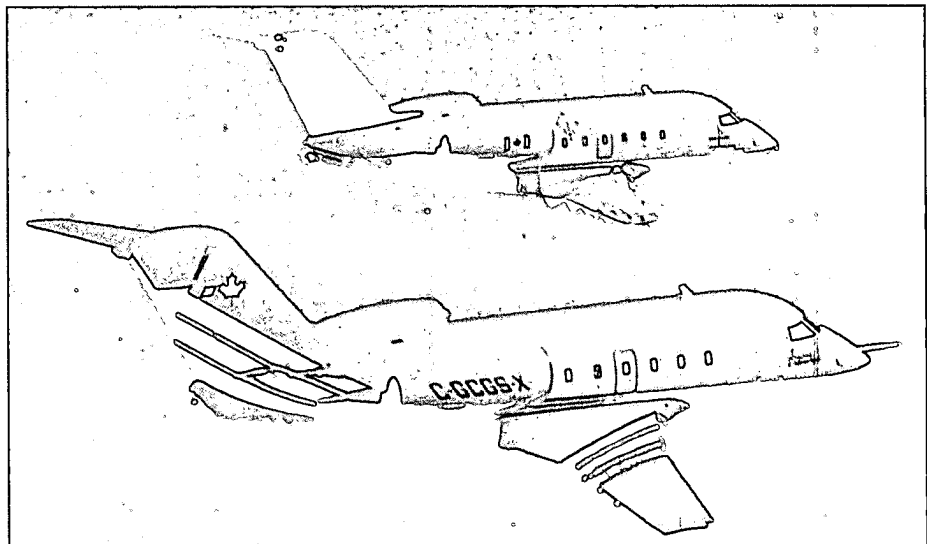
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Canadair Challenger 19
passenger business, cargo and
commuter transport

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Financially Troubled Canadair

Canada's largest airframe producer, Canadair, lost \$1.1 billion in 1982, the largest single corporate loss in Canadian history. Ottawa has provided the government-owned company with more than \$1.3 billion in loan guarantees and other funds to keep it afloat, and the company is expected to ask for \$150 million more to get through 1984.

produced only 125 transport aircraft in 1982, 45 fewer than in 1981. Sales remained slow in 1983, and we do not expect them to improve much in 1984. The drop in sales badly weakened the financial position of the Canadian industry, and Canadair and de Havilland lost a combined total of \$1.4 billion in 1982.¹ Losses continued in 1983, and the two companies are depending on government funds to stay afloat.

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Canadair's losses are attributed to its Challenger aircraft—a business, cargo, and commuter aircraft capable of carrying 19 passengers. Design and management problems plagued the plane from the outset, and by 1981 costs were 12 times greater than the original 1976 forecasts. By October 1983 only 79 Challengers had been sold versus current estimates that 389 planes must be sold to break even; industry analysts doubt that will ever occur. The Challenger represents 60 percent of Canadair's total effort and is responsible for one-half of its employment.

An Emerging Industrial Strategy

Because of the financial troubles and increased competition faced by the industry, Ottawa is developing a comprehensive aerospace strategy, focusing on those products that have already been successfully marketed. A June 1983 task force report made several recommendations for improving Canada's competitiveness in the aerospace industry. In particular, the report called for greater government support for research and development, additional export financing, and increased involvement in joint ventures.

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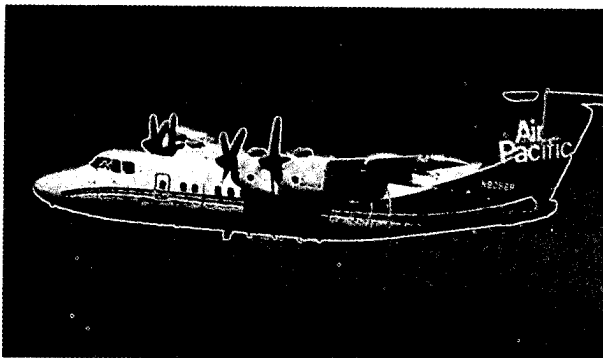
In 1982-83, the recession sharply reduced global demand for new commuter aircraft, while foreign competition increased with the introduction of several new models. As a result, Canadian companies

¹ All values in this article are expressed in US dollars.

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De Havilland Dash 7 50-seat STOL transport, sold primarily to commuter airlines []

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Research and Development. R&D is probably the most critical element in the maintenance of a viable aerospace industry because of the rapid pace of technological change. Although the industry has historically devoted 10 percent of revenues to R&D—making the aerospace industry responsible for 20 percent of the country's total R&D activity—Canada still lags other countries in expenditures on R&D. Thirty percent of the \$1 billion in aerospace R&D expenditures between 1972 and 1981 came from the federal government, mostly through the Defense Industrial Productivity Program (DIPP). Originally set up to provide R&D assistance to defense-related industries, most DIPP funds now go to commercial aerospace applications. The development of the Dash 7 STOL transport and several aircraft engines were funded in part by DIPP. []

A forerunner of Ottawa's new industrial strategy has been a series of small—mostly less than \$1 million—grants made to several aerospace firms in 1983. Ottawa also will contribute \$380 million to Pratt and Whitney Canada's (PWC) \$1.4 billion R&D program over the next 10 years; a large part will go to develop engines for the new Canadian helicopters. []

The task force report recommends additional government support for the industry through DIPP and the National Research Council. Most important, it proposed that Ottawa make its R&D appropriations on a five-year rather than year-by-year

basis. If adopted, this recommendation could smooth out the planning process and speed development. []

Trade Promotion. Export financing is critical in the marketing of aerospace products, and we believe Ottawa will provide large and more timely export credits as recommended by the task force. Sales of de Havilland's Dash 7 and Dash 8, in particular, probably would benefit from increased export financing. During 1980-82 \$453 million of Canada's aerospace exports received either financing by the Export Development Corporation or commercial loan guarantees by the federal Enterprise Development Board (EDB). []

Ottawa supports the GATT aerospace agreement controlling the international application of export financing in the industry but is concerned that the "consensus interest rate" of 12 percent is frequently violated. The task force report recommends that funds be made available to the EDC to be used in actions against violators of the GATT consensus. Ottawa, however, may be reluctant to do this in the face of international pressure to support the GATT. []

Joint Ventures. The task force supports Canada's participation in joint ventures. Given the high cost of producing aircraft, it is likely that manufacture increasingly will be undertaken by several companies under joint and often international agreements. Ottawa currently is negotiating a 10-percent stake in the 150-seat Airbus Industrie A320 being developed under the direction of the French. According to press reports, government officials, however, are not pleased with the limited technological involvement offered the Canadian industry in the new package, and the shaky financial positions of both de Havilland and Canadair may preclude the Canadians from participating. []

Outlook

Ottawa aims for a doubling of sales of aerospace products by 1987—a target we consider overoptimistic. On the plus side, the economic recovery will

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Canada Moves Into Helicopter Production

In October, Ottawa announced the Canadian aerospace industry's expansion into helicopter production with a new \$410 million production facility in Montreal. More recently, the planned construction of a second, much smaller plant in Ontario was disclosed. The announcements culminate three years of effort by the Department of Industry, Trade, and Commerce to attract a helicopter manufacturer to Canada. Trade Minister Ed Lumley believes Canada's "large domestic market and skilled population make the helicopter industry a natural for us." He also believes that the transition to helicopter production will be easy because "of the five basic components that go into a helicopter, four are made in Canada. . . ." Ottawa hopes that domestic production will help offset a growing trade deficit in helicopters and parts. The industry forecasts 15,000 to 16,000 helicopters will be sold in the next decade, with the new twin-turbine engined craft—such as these plants will produce—increasingly replacing other models in the fast-growing civilian helicopter market. The helicopter industry, however, is very competitive, and we believe Ottawa's estimates of obtaining 40 percent of the world market by the mid-1990s are overly optimistic.

improve sales, and the commuter aircraft market is growing more rapidly than other aircraft markets. Nonetheless, we believe that the industry's financial problems, coupled with intensifying global competition, make Ottawa's goal unrealistic. For example, the venture into helicopter production, while it illustrates Ottawa's desire to promote more widely based aerospace industry, is highly risky given the fiercely competitive market.

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Canada's aircraft industry—at least the parts and components sector—appears headed toward closer integration with the US aerospace industry. Ottawa has expressed interest in strengthening defense-sharing agreements with the United States to benefit from increased US military spending. Canada is increasingly reliant on US military products, and Ottawa, therefore, probably will continue to push for a large part of the work to be done in Canada to offset purchase costs.

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India's Green Revolution: The Bills Come Due

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Although India is looking forward to a record foodgrains harvest during the 1983/84 season, the country's agricultural prospects are clouded by slower growth in yields and rapidly escalating production costs. Already the slowing of the growth rate in agriculture and rapidly rising costs have expanded agricultural subsidies and pushed up politically sensitive food prices. New Delhi's efforts to increase food production and keep the lid on consumer prices and budget deficits will challenge policy planners and are likely to strain relations between New Delhi and state governments. Any government move to reduce agricultural subsidies will be difficult because farmers represent an increasingly important political force.

growth in rice yields and production has slowed. Overall, the improvement in foodgrain production has been modest relative to the investment in new technologies.

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Higher Costs, Lower Returns

Input costs over the past decade have grown twice as fast as farm income. Unlike industry, where new technology is usually associated with lower unit costs and higher productivity, in India's small farm agriculture the new high-yielding technology has caused unit costs to rise faster than production, slowing farm income growth.

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The Green Revolution and Food Production

With the advent of the Green Revolution in the mid-1960s, India has been able to approach foodgrain self-sufficiency and reduce food imports. The extension of irrigation, the introduction of high-yielding seed varieties, and the use of chemical fertilizers and pesticides have increased foodgrain production from an average of 66 million tons in the 1950s to an average of 134 million tons by the early 1980s. The new high-yielding varieties, unknown to farmers less than 20 years ago, now are cultivated on nearly 80 percent of India's wheatland and 55 percent of its riceland.

In the major surplus food-growing states, producers have devoted an increasing proportion of output to meet the rising cost of inputs. In Haryana and Punjab, northern India's granary and the first states to adopt the new seed technologies, yield levels have stagnated, while input costs have risen an average of 7.5 percent per year. The situation in India's ricegrowing regions is worse; costs frequently exceed the value of output, according to Indian agricultural economists.

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The Burden of Subsidies

The steady growth in food production, however, must be weighed against a 12-percent annual increase in the use of expensive farm inputs since 1970 and the lackluster performance of crops other than wheat. Foodgrain production has grown at an average annual rate of only 2.4 percent since the late 1960s, as compared with 3.1-percent annual growth before the Green Revolution. The average annual growth of wheat yields has doubled, with output growing 5 percent per year, whereas the

Indian planners have traditionally viewed agricultural subsidies as a means of stimulating production while keeping food prices low. Since the early 1950s, an elaborate subsidy and agricultural market control system has evolved. Subsidies were considered essential to encourage the adoption of the higher cost new-seed technologies; market controls were instituted to regulate foodgrain prices. Once subsidies were in place, however, they became politically difficult to eliminate.

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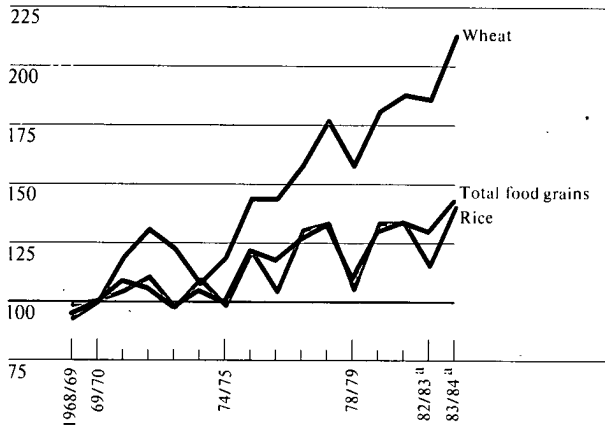
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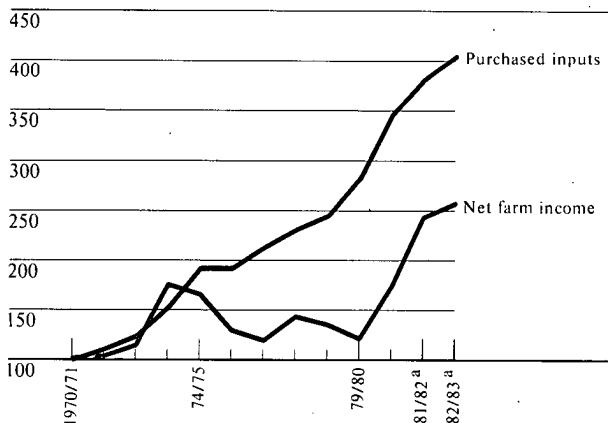
India: Agricultural Statistics

Note scale changes

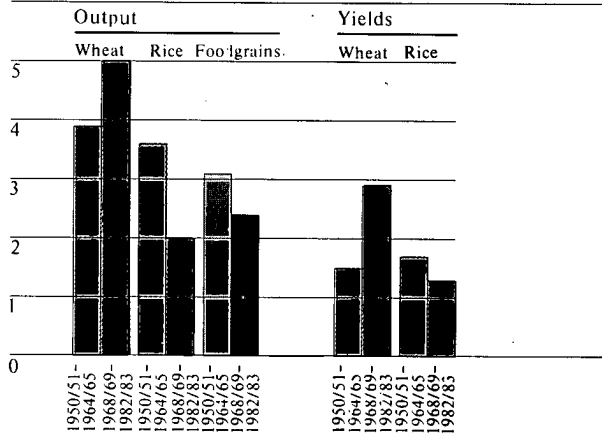
Growth of Food Production During the Green Revolution
Index: 1969/70=100



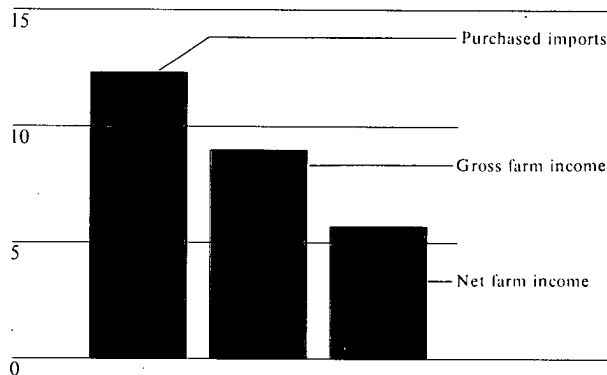
Input Costs and Farm Income
Index: 1970/71=100

^a Estimated

Growth Rates of Agriculture Output and Yields
Percent



Growth Rates of Input Cost and and Farm Income, 1970/71-1982/83
Percent



As oil prices soared, subsidies to petroleum-based agricultural inputs escalated, straining both state and national budgets. Most agricultural input subsidies are administered at the state level where farmers exercise considerable influence. In our view, farmer pressure since 1975 has played a

major role in the doubling, in real terms, of the combined subsidies on chemical fertilizers, irrigation, rural development projects, and electrical power. The World Bank estimates that in fiscal year 1981/82 \$2.7 billion was allocated to agricultural subsidies, an amount close to one-half the

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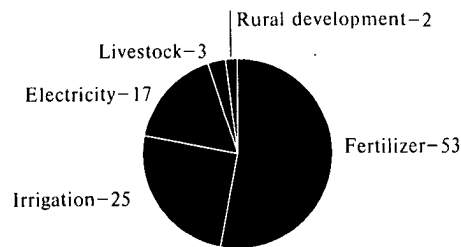
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India: Growth of Agricultural Subsidies

Percent

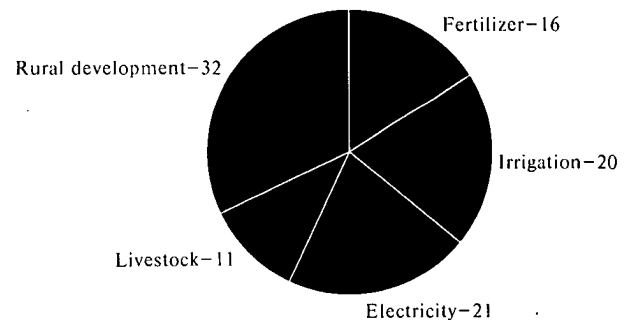
1974/75

US \$ 1.3 billion (in 1981 dollars)



1981/82

US \$ 2.7 billion (in 1981 dollars)



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total public expenditures on agriculture. In addition, indirect subsidies are provided in the form of below-market-rate cooperative credit loans. Compounding the burden, approximately one-half of these loans are overdue, with little chance of recovery.

The large and growing Indian subsidy program has partially masked the higher cost structure of the new technologies, thereby inducing inefficiency. World Bank studies of Indian agriculture indicate that direct and indirect subsidies distort prices faced by farmers, minimize true costs, and encourage a misallocation of resources. Subsidies probably widen gaps in farm incomes because the larger, more prosperous farmers benefit the most.

Outlook

Although we expect food production will continue to rise in the 1980s, increased output will require more costly inputs, which not only will push up food

prices and subsidies, but also will limit resources for alternative investments. Higher foodgrain procurement prices over the past three years have been spurred by steadily rising production costs. In our view, higher procurement prices have contributed to higher food prices despite record harvests. We believe that if subsidies continue to grow they may constrain available finances needed to boost production of rice and edible oil, and India's imports of these commodities would continue to grow.

We consider the problem of containing burgeoning subsidies while providing incentives to farmers to be the critical agricultural policy dilemma for India in the 1980s. Any government move to reduce agricultural subsidies will be difficult because farmers represent an increasingly important political force. Subsidies to irrigation, rural power users, and financial institutions remain largely the prerogative of state governments. New Delhi has leverage over state government budgets, but the

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states maintain control of key rural financial institutions as well as power and irrigation facilities. Since state assemblies are more vulnerable to rural constituent pressure than the national government, needed reforms will be difficult to implement. Moreover, we believe that both federal and state governments fear that if commodity prices do not rise and if input subsidies are reduced too rapidly, widespread farmer protests—as occurred in 1980—will resume [redacted]

[redacted]

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